

ORIGINAL

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of

Request for Review by McLeodUSA
Telecommunications Services, Inc.
Universal Service Administrator Decision

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CC Docket No. 96-45
CC Docket No. 97-21

To: The Commission

MCLEODUSA TELECOMMUNICATIONS SERVICES, INC.
REQUEST FOR REVIEW OF UNIVERSAL SERVICE
ADMINISTRATOR DECISION

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Summary

On August 1, 2007, the Universal Service Administrative Company ("USAC") issued an Audit Report regarding McLeodUSA Telecommunications Services, Inc. ("McLeodUSA"). McLeodUSA believes several of the audit findings are incorrect and reflect erroneous factual conclusions and errors in application of FCC regulations and governing law.

Specifically, McLeodUSA is appealing three USAC audit findings. The first, Audit Finding #1, concerns USAC's improper reclassification of intrastate revenue from private line services as interstate revenue. McLeodUSA also requests the reversal of Audit Finding #2 in which USAC has incorrectly attempted to require McLeodUSA to pay the USF fees and penalties owed by its reseller customers. Finally, Audit Finding #5 should be overturned since USAC has ignored the facts and documentation and mistakenly reclassified over two million dollars of revenue, including substantial portions of intrastate and non-telecommunication revenue as interstate telecommunications revenue.

As all of these errors demonstrate, USAC had a continuing bias towards the reclassification of revenue as interstate telecommunications revenue, and thus was not a neutral auditor. They ignored or dismissed facts provided by McLeodUSA and repeatedly requested additional and more detailed documentation after discounting the information already presented to them. In addition, not only did they fail to review or analyze the information provided by McLeodUSA, but they also failed to account for or review the information on the Commission's own publicly-available database.

In assuming revenue was interstate telecommunications, instead of actually reviewing the facts of the situation, USAC clearly ignored and acted contrary to the instructions to the Form 499-A as well as, FCC rules and precedent. For all of these reasons, the Commission must

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review and reverse these audit findings by USAC as factually incorrect and an improper application of FCC regulations and precedent.

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I. INTRODUCTION

McLeodUSA Telecommunications Services, Inc. ("McLeodUSA"), through its undersigned counsel and pursuant to Sections 54.719(c), 54.721 and 54.722 of the Rules of the Federal Communications Commission ("FCC" or "Commission") hereby respectfully submits this request to review to reverse several findings issued by the Universal Service Administrator Company ("USAC") to McLeodUSA on August 1, 2007.

McLeodUSA requests the Commission's review and reversal of several USAC audit findings. As McLeodUSA proves in the following discussion, USAC ignored facts and documentation presented by McLeodUSA regarding its products, services and related jurisdictions. Instead of properly reviewing and analyzing the information provided, which demonstrated the services were intrastate or non-telecommunications in nature, USAC instead simply dismissed the facts and improperly reclassified the revenue as interstate. In addition, USAC improperly reclassified McLeodUSA's reseller revenue as end user revenue, despite evidence in the FCC's own database that a significant number of these companies were USF

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contributors. These actions and findings are contrary to federal law, FCC rules and regulations and the instructions to the Form 499-A, and must be reversed by the Commission.

II. FACTUAL BACKGROUND

McLeodUSA is a telecommunications service carrier headquartered in Iowa and provides competitive local and long-distance service to residential and business customers in approximately 25 states, offering integrated voice and data services, including virtual private lines, DSL, long distance and toll-free services. As a telecommunications service provider, McLeodUSA is registered with the FCC and has contributed to the USF since it began providing telecommunications services in 1994.

In early 2007, USAC notified McLeodUSA of its intention to conduct an audit of McLeodUSA's 2006 Form 499-A filing (reporting revenue for calendar year 2005). In February 2007, USAC conducted a site visit at McLeodUSA's offices. The draft Detailed Audit Report was issued on March 8, 2007. McLeodUSA prepared and filed a response to the original audit report on April 13, 2007 and provided two supplements by letter to USAC, first on May 11, 2007 and the second on May 18, 2007.¹ The final audit report was issued by USAC on August 1, 2007.² The audit focused on several products and services, described below, that were offered by McLeodUSA during the relevant time period.

Among other services, McLeodUSA offers private line circuits that provide dedicated connectivity from one location to another location. These services can have voice and/or data transmissions, but only to the dedicated end point of the service. These services do not access

¹ Hereinafter referred to respectively as the April 13 Response, May 11, 2007 Letter and May 18, 2007 Letter. The May 11, 2007 and May 18, 2007 letters are attached hereto as Exhibit G.

² The notification of Board approval and final audit report was provided by e-mail message from Christy Mi, USAC Staff Auditor to William A. Haas, Deputy General Counsel, McLeodUSA on August 1, 2007. Hereinafter that report is referred to as the "Final Audit Report." Note that the Final Audit Report that was issued on August 1, 2007 has the incorrect date of March 13, 2007. The Final Audit Report and electronic correspondence are enclosed as Exhibit B.

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any type of common carrier long distance, local or data switches that would allow them to reach outside the boundaries of these designed circuit. McLeodUSA also offers an FX800 product that is a traditional Foreign Exchange service used to provide a customer a local telephone number in one local exchange to service a physical location in another local exchange. McLeodUSA also offers Integrated Access (both IP and TDM based) and Local T-1 lines, which are both provided pursuant to intrastate tariffs. Its Integrated Access product is a service that provides switched voice service, including local voice, and dedicated data service over a single port and T1 access loop. The Local T-1 service provides DID or trunk side local service to a customer and can be used instead of a traditional local service.

McLeodUSA asserts that several of USAC's final audit findings are factually incorrect, contrary to the Form 499-A Instructions and FCC rules and should be reversed by the Commission. In the Final Audit Report, USAC made seven audit findings regarding McLeodUSA's 2006 Form 499-A filing. McLeodUSA hereby objects to and requests review and reversal of three of those findings. In Audit Finding #1 concerning private line revenue, USAC ignored evidence provided by McLeodUSA that those services—private lines, FX800, and Integrated Access and Local T-1—were intrastate services and/or services provided to resellers and, therefore, exempt from USF contribution base as either intrastate or "carriers' carrier" revenue. Instead, USAC reclassified most, if not all, of the revenue from those services as interstate, claiming that documentation provided by McLeodUSA in response to USAC's requests was not what USAC wanted to prove their intrastate status or wholesale nature. Regardless of the oddity of USAC rather than the carrier determining what is appropriate documentation, McLeodUSA has subsequently provided USAC with yet more documentation, in an attempt to provide USAC with information sufficient to satisfy USAC that the intrastate

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services provided by McLeodUSA are indeed intrastate.³ Similarly, in Audit Finding #2, USAC reclassified the revenue from 553⁴ of McLeodUSA's customers based on the (incorrect) assumption that none of the companies had contributed to USF. As discussed in detail below, while some of the entities may have been inadvertently misclassified as carriers' carriers, USAC failed to perform even the most basic review or diligence regarding those carriers and therefore failed to recognize that over half of the entities it identifies as not registered do in fact have 499-A Filer IDs and most of these entities are listed as current contributors to the USF on the Commission's publicly-available USF filer database. By attempting to reclassify this revenue as end user revenue, USAC also acted contrary to FCC Rules and Regulations by unilaterally acting as if it could transform reseller revenue to end user revenue without conducting any actual review of the facts. Finally, in Audit Finding #5, USAC mistakenly reclassified over two million dollars in "Other Charges and Credits" as interstate revenue and claimed that McLeodUSA provided insufficient documentation to prove otherwise. In fact, McLeodUSA provided ample documentation that the revenue in question was, in significant portions, either not telecommunications revenue or was *intrastate* telecommunications revenue. While some of this revenue is properly classified as interstate revenue, USAC's approach of declaring 100 percent of the revenue as interstate telecommunications, based on solely an assumption rather than a factual inquiry, is facially invalid.

McLeodUSA hereby requests that the Commission review and reverse USAC's Audit Finding #1 on private line revenue, Audit Finding #2 on reseller revenue and Audit Finding #5

³ This information included lists of customers who have certified that their use of the circuits is intrastate, as described in greater detail on page 7 and Exhibit F.

⁴ It should also be noted that while USAC indicated that it had identified 553 companies as end users instead of resellers in its Final Audit Report on page 17, when USAC actually provided a list of those resellers to McLeodUSA on September 5, 2007, it listed 549 separate entries. In addition, in reality, the number is closer to approximately 233 entities, as USAC counted multiple account numbers of the same entities as separate companies.

on non-telecommunications revenue as containing significant errors, both factual and legal, as detailed further below.

III. ARGUMENT

A. USAC Erroneously Reclassified Intrastate Revenue As Interstate Revenue

USAC's audit of and final conclusions regarding McLeodUSA 2006 USF filing were based on little more than assumptions and a bias toward declaring revenue as interstate telecommunications revenue and therefore have little resemblance to the facts or documentation provided by McLeodUSA. Throughout this audit and in its analysis of McLeodUSA's responses, USAC ignored and dismissed factual statements and documentation provided by McLeodUSA demonstrating that its various services should be classified as intrastate and instead continued to insist upon different documentation than what McLeodUSA maintains in the ordinary course of business to support the company's intrastate classification of its services. Within both Audit Finding #1 regarding private line revenue and Audit Finding #5 addressing "Other Charges and Credits," USAC rejected and ignored documentation provided by McLeodUSA and instead made the unsubstantiated decision to simply declare the revenue to be interstate without regard to the facts.

1. **USAC failed to conduct any due diligence analysis, improperly dismissed the facts presented, and did not properly adhere to Form 499-A instructions.**

USAC's repeated demands for additional "evidence" or claims that the evidence provided was not "complete" was simply an attempt by USAC to avoid its responsibilities to fully review and analyze the information provided. USAC continued its demands for additional information, thus blatantly ignoring McLeodUSA's statements regarding the proper reporting of its revenue. For example, in its April 13 Audit response, McLeodUSA informed USAC that its private line service had no access to long distance, local or data switches and therefore could not access any

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areas outside of the line's designated boundaries.⁵ Hence, the private line service could not possibly have contained more than ten percent interstate traffic, or generated interstate revenue, and thus should not have been categorized as an interstate service by USAC. After summarily rejecting McLeodUSA's statement that its private line product provided only intrastate service, USAC asserted that "without any evidence to support this statement, IAD cannot conclude that the private line contains local traffic only."⁶ Similarly, in reference to the FX800 product, USAC asserted that additional evidence was necessary to support McLeodUSA's position that the product was intrastate in nature. Regarding McLeodUSA's Integrated Access/T-1 services, the company explained to USAC that a significant number of customers purchase that service as a replacement for their local dial tone service or for intra-corporate network communications.⁷ In addition, McLeodUSA informed USAC that it not only provides Integrated Access/T-1 service as an intrastate-only service, but had previously taken action to ensure that its use by customers was consistent with that intent. "McLeodUSA can demonstrate that it has disconnected customers that have misused Local T-1 service for making non-local calls...."⁸ In fact, McLeodUSA offered to provide substantiating evidence of these actions if USAC so required.⁹ However, USAC never requested this information and proceeded to issue its report based on its initial assumptions without further review of the facts. "McLeod[USA] stated in its response that its private line services do not access any type of long distance. However, without any evidence to support this statement, IAD cannot conclude that the private line contains local

⁵ See April 13 Response at 1.

⁶ Final Audit Report at 12. It should be noted that McLeodUSA did provide supporting documentation, including its intrastate tariff, as described on pages 9-10. Subsequently, on October 1, McLeodUSA provided USAC a summary of customer certifications that the service was intrastate. IAD is USAC's Internal Audit Division.

⁷ April 13 Response at 3.

⁸ See April 13 Response at 4.

⁹ See Exhibit A, Affidavit of William Haas.

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traffic only.”¹⁰ Short of having USAC perform site inspections of each circuit to verify that the circuit does not connect to a McLeodUSA or IXC switch, the standard used by USAC makes it virtually impossible for any carrier to disprove that less than ten percent of the revenues are interstate. Notwithstanding this impossible threshold USAC attempts to set through its audit finding, upon conducting its own further due diligence of the issue, McLeodUSA sent its customers certifications asking them to confirm the intrastate nature of their traffic. McLeodUSA received confirmation from 369 of its private line customers, reflecting 40% or 918 of the company’s private line circuits, that in 2005, the subject year of the audit, 78% of those circuits were used for 90% or more intrastate use.¹¹

In addition, when McLeodUSA did provide documentation, USAC also largely dismissed it without cause. For instance, McLeodUSA provided documentation requested in response to Audit Finding #5 regarding “Other Charges and Credits.” In its April 13 Response, McLeodUSA noted that while some of the revenue reported as “Other Charges and Credits” may have been interstate telecommunications revenue that was mistakenly recorded as non-telecommunications revenue, the documentation provided to USAC clearly showed that the whole amount listed under that category was not entirely telecommunications revenue and certainly was not completely comprised of interstate revenue as USAC claimed. For example, charges for “dial-up internet” and “maintenance charges” were included in McLeodUSA’s calculation of its “Other Charges and Credits” and yet it was these categories of revenue along with others that were moved from non-telecommunication revenue to interstate revenue by

¹⁰ See April 13 Response at 12.

¹¹ See Exhibit A, Affidavit of William Haas. See also Exhibit F, Summary of Certifications.

USAC.¹² Further, pages of the list of charges are clearly designated as “local charges” or “local usage” and identify the account number or phone number associated with the charges. The complete list of charges that was provided to USAC is attached hereto as Exhibit E. Because these charges were summarized, it is true that McLeodUSA could not provide specific billing data for each specific charge for 2005. But, contrary to the implications in the Final Audit Report, McLeodUSA not only provided documentation during the audit regarding these charges, but provided additional documentation in its May 11, 2007 Letter. Based on that documentation, USAC conceded that a mere \$[REDACTED] of the \$[REDACTED] in “Other Charges and Credits” should be reclassified as intrastate revenue.¹³ McLeodUSA even offered to provide the 2006 data for each individual charge so that USAC could conduct its own review of the relative size of each charge in the whole of “Other Charges and Credits”. USAC declined to review this information, and continued to assert that the remaining \$[REDACTED] should be classified as interstate revenue because “without *further* supporting documentation” it could not agree with McLeodUSA’s statements that the charges were for non-telecommunications and intrastate services.¹⁴ Again, its lack of thorough analysis or due diligence with the documentation provided caused USAC to simply ignore its responsibilities to conduct an actual review of the revenue by making assumptions rather than reaching conclusions that the revenue to interstate without regard to the actual facts of McLeodUSA’s services.

McLeodUSA does not know why USAC arbitrarily dismissed its factual statements and the documentation that was provided. McLeodUSA stated that the services discussed in Audit Finding #1 were used only for intrastate communications, that they have no access to long-

¹² As USAC knows, local service revenue is intrastate and maintenance charges are non-telecommunications revenue. Therefore, reclassifying these charges as interstate clearly violates FCC rules and the Form 499-A instructions.

¹³ Final Audit Report at 31.

¹⁴ *Id.* (emphasis added).

distance service or are used by a reseller carrier, and therefore was exempt from contribution to USF. In addition, McLeodUSA provided documentation clearly supporting its assertion that the revenue reported as "Other Charges and Credits" was either intrastate or non-telecommunications. USAC also clearly admits that McLeodUSA made those statements and assertions. In addition, USAC provided no evidence or allegations that McLeodUSA was in any way incorrect or fraudulent when it made those statements. Yet, it simply rejected McLeodUSA's statements and documentation, with no justification whatsoever, and reclassified the intrastate and non-telecommunications revenue as interstate revenue. Such actions were mistaken, incorrect and without support in law or FCC Rules. Without proper claims and evidence that McLeodUSA's statements regarding the intrastate nature of the service were incorrect, USAC should have accepted them as accurate. As McLeodUSA's subsequent diligence has demonstrated, McLeodUSA's assertions were and has now provided the information USAC requested despite there being no legal requirement for McLeodUSA to do so.

In addition, USAC acted contrary to the Form 499-A instructions when it reclassified the intrastate revenue generated from McLeodUSA's FX800 and Integrated Access and T-1 services. USAC incorrectly concluded that the FX800 product provided by McLeodUSA "is mainly used to initiate long distance calls" and reclassified the revenue from the product as 100% interstate since McLeodUSA did not provide traffic studies for that service.¹⁵ However, this reclassification is contrary to the *Form 499-A Instructions*. As McLeodUSA indicated in its response, the FX800 service is an intrastate service and is provided under the company's intrastate tariff.¹⁶ The instructions to the Form 499-A itself provide that services should be reported as they are tariffed and, therefore, revenue from the FX800 service was properly

¹⁵ April 13 Response at 5.

¹⁶ See Exhibit C, McLeodUSA's Iowa Intrastate Tariff.

reported as intrastate.¹⁷ Likewise, McLeodUSA's Integrated Access and Local T-1 services are provided under the company's intrastate tariff and revenues from those services were reported as intrastate.¹⁸ McLeodUSA provided USAC with the copies of the relevant intrastate pages of its tariff. Despite receiving this evidence, and instead of following the instructions, USAC improperly concluded that these services were interstate in nature. The FX800 service and the Integrated Access and Local T-1 services are purely intrastate in nature, are tariffed as intrastate services and USAC's findings should be reversed.

2. USAC misapplied and incorrectly utilized the ten percent rule.

USAC also improperly interpreted and incorrectly applied the ten percent rule to support its transfer of intrastate revenue to interstate revenue. That rule simply states that "[i]f over ten percent of the traffic carried over a private or WATS line is interstate, then the revenues and costs generated by the entire line are classified as interstate."¹⁹ Contrary to USAC's application of the rule, it does not create the presumption that that usage is *interstate* unless proven otherwise. Instead, the rule creates exactly the opposite presumption - that usage in *intrastate* unless proven otherwise. The standard practice within the telecommunications industry is not to assume that geographically intrastate private lines are interstate in nature. Carriers obtain regulatory authority to offer such services through the states and intrastate private lines are normally tariffed, as are McLeodUSA's FX800, Integrated Access and T-1 services, as intrastate services. In addition, the early development of the ten percent rule supports the presumption that usage is intrastate instead of interstate. In adopting the rule, the Federal-State Joint Board decided that carriers may want to request certifications from their customers indicating that

¹⁷ "Revenues from services offered under interstate tariffs ... should be identified as interstate revenue." Clearly, if services provided under interstate tariff should be classified as such, then revenues from services provided under intrastate tariffs should be classified as such. See March 2006 Form 499-A, Instructions at 19.

¹⁸ See Exhibit C, McLeodUSA's Iowa Intrastate Tariff.

¹⁹ March 2006 Form 499-A, Instructions at 19.

“each of their special access lines carries *more than* a de minimis amount of interstate traffic.”²⁰

If the FCC had intended to create a presumption that carrier traffic was interstate, instead of intrastate, they would have drafted the certification differently by asking customers to declare that that there was 10% or *less* interstate traffic use of the circuit, creating a presumption of interstate use.

USAC has used the ten percent rule to classify private lines services such as the FX800 service as entirely interstate while improperly dismissing statements by McLeodUSA that the service should be classified as intrastate.²¹ Additionally, the reclassification of revenue from these intrastate services by USAC is directly in violation of federal law declaring that the FCC, and hence USAC, has no jurisdiction to include intrastate revenues within the universal service contribution calculations.²² Yet, USAC has once again jumped to a conclusion and transformed intrastate revenue into interstate revenue simply by declaring it so in absence of some heretofore unknown means of disproving USAC’s assumptions. The Commission must reverse the audit findings and instruct USAC that its application of the ten percent rule was contrary to the rule’s intent and purpose.

3. USAC’s audit findings ignored FCC precedent and were based on policies not approved through the proper APA procedure.

Even assuming that the services in question are indeed subject to the FCC’s ten percent rule for purposes of determining whether jurisdiction lies with the Commission, it is not at all clear that this rule is appropriate for determining whether USF contribution is due on that revenue. Recently, a federal court considering this issue raised doubts as to whether the use of

²⁰ See *In the Matter of MTS and WATS Market Structure Amendment of Part 36 of the Commission’s Rule and Establishment of a Joint Board*, Order, 4 FCC Rcd 5660, at ¶ 3 (1989) (emphasis added).

²¹ “USAC will require more supporting documentation than a generic statement from the carrier.” Final Audit Report at 14.

²² See *Texas Office of Public Utility Counsel v. FCC*, 183 F.3d 393, 448 (5th Cir. 1999).

the ten percent rule as the basis for assessing USF contribution was lawful, under the Administrative Procedures Act (“APA”). In *Telstar Resource Group, Inc. v. MCI, Inc.*, the court determined that the application of the ten percent rule to USF calculations is not clearly authorized by the FCC and has ordered the parties to seek clarification from the FCC as the agency with primary jurisdiction on the issue.²³ The court found that the ten percent rule arose from a ratemaking proceeding and had no clear connection to the calculation of USF fees. “The FCC’s jurisdictional separations scheme, to which the Ten Percent Rule belongs, arose to guide cost allocation for the purposes of ratemaking, and it does not appear to apply expressly to the calculation of USF contributions.”²⁴ The court noted that “in light of the FCC’s apparent use of the rule *outside* of its original ratemaking context, the Court cannot say with certainty how far and wide the FCC intends the rule to apply.”²⁵

This ruling calls into question the applicability of the ten percent rule in the USF context,²⁶ yet USAC continues to apply the rule in its audit analysis as if it has clear and undisputed authority from the FCC to do so. Instead, the only “authority” for USAC’s application of the rule in the USF context is its own instructions and those instructions were not subject to a formal rulemaking proceeding. In addition, USAC’s authority is limited, and it does not have independent authority to develop or implement rules in its capacity as administrator. If the FCC wished to actually expand the ten percent rule to apply to this heretofore unused application, the APA requires notice and comment periods on any new rules.²⁷ The application of the ten percent rule to USF analysis has not been clearly established in a FCC rulemaking and the use of the rule by USAC, supported only by the citation of the rule in their instructions, is a

²³ *Telstar Resource Group, Inc. v. MCI, Inc.*, 476 F.Supp.2d 261 (S.D.N.Y. 2007).

²⁴ *Id.* at 270.

²⁵ *Id.* (emphasis added)

²⁶ *Id.*

²⁷ 5 U.S.C. § 553(b)-(c).

violation of the APA, because no such rulemaking, complete with public notice and an opportunity for comment, occurred. Therefore, the FCC must reverse USAC's findings and apply USF only on private lines that are actually providing interstate connectivity, and not merely those which may happen to carry interstate traffic while being physically intrastate.

B. USAC Improperly Reclassified Reseller Carrier Revenue As End-User Revenue

During the audit, McLeodUSA indicated that 801 carriers were reseller customers of the company. Of those 801 carriers,²⁸ USAC improperly reclassified the revenue from 553 of them because the auditors believed that those resellers did not directly contributed to USF. "As a result, IAD reclassified \$[REDACTED] as end user revenue to Block 4 of the 2006 Form 499-A for those carriers that did not contribute to the USF according to USAC records."²⁹ In addition, USAC Management concurred with Audit Finding #2 and stated that "USAC Financial Management concurs in IAD's finding. The revenue that has been moved from Block 3 to Block 4 was from companies that were not direct contributors to the USF in 2005."³⁰ USAC determined that McLeodUSA did not "establish a basis for reasonably expecting these carriers were contributors during the filing period."³¹ Upon an internal review, McLeodUSA determined that due to an inadvertent error, a portion of enterprise customers were reported as resellers. This problem has been remedied. But, regardless of any errors that may have occurred, USAC is not entitled to rely on this limited error to reclassify the remaining entities as "end users" when it has failed to actually consider the facts provided by McLeodUSA or that are publicly available.

²⁸ While USAC identified 801 carriers, McLeodUSA believes this number is significantly inflated as it counts multiple account numbers for the same entity. *See supra* note 3.

²⁹ Final Audit Report at 17.

³⁰ *Id.* at 21.

³¹ *Id.* at 17.

USAC based its movement of that revenue partially on which companies McLeodUSA had readily available reseller certificates to provide to USAC. However, USAC placed too much evidentiary weight on reseller certifications and not enough on the actual facts. If a reseller customer is an USF contributor, McLeodUSA has no obligation and no need to require that the company provide a certification under the Commission's rules. Despite the fact that the certification is not mandatory, USAC repeatedly insisted that McLeodUSA produce certifications, and when it was unable to, USAC arbitrarily reclassified the revenue of 553 carrier customers as end-users because McLeodUSA could not have "reasonably" expected those carriers to be contributors.

Interestingly, USAC itself instructs McLeodUSA that it may "reasonably expect" that resellers are USF contributors if they are listed as such in the FCC database. "The FCC website ... identifies carriers currently contributing to the fund and documenting a check of the website can provide a basis for reasonably expecting particular resellers are contributing."³² McLeodUSA reasonably expected that many of its reseller customers were contributors based on the FCC database, yet USAC ignored the Form's instructions, its own internal recommendations as well as the basic facts to reclassify the revenue from these companies as end-user revenue.

For example, as demonstrated on the attached list at Exhibit D, [REDACTED] is the largest McLeodUSA reseller customer whose revenue was improperly reclassified by USAC. McLeodUSA is baffled as to how USAC could possibly claim that McLeodUSA could not have *reasonably expected* [REDACTED], a well known incumbent LEC, to be a contributor to USF. [REDACTED] is a significant incumbent local exchange carrier that generated [REDACTED] in net income in the second quarter of 2007³³ and it is registered with the FCC.³⁴ Other reseller

³² Final Audit Report at 19.

³³ [REDACTED].

customers of McLeodUSA, including [REDACTED], [REDACTED] and [REDACTED] are registered with the FCC, are contributors to USF and are either competitive or incumbent LECs. Through its own due diligence and review of the FCC database as part of its preparation for this filing, McLeodUSA easily discovered that the majority of the revenue moved by USAC was revenue that had been billed to resellers who are registered with the Commission and have Filer IDs. In fact, as shown in Exhibit D, at least six million dollars of the approximately ten million dollars reclassified by USAC was generated from resellers registered with the Commission. Obviously, USAC failed to conduct even the most basic review of its own database because, had they done so, they would have determined that approximately 60% of the revenue moved by USAC was from registered resellers.

Of the more than 60% of the resellers that were registered with the FCC (despite USAC's conclusion to the contrary), 80% of these, or approximately \$4,263,395 in revenue, are listed in the database as current contributors. The Form 499-A instructions are clear that the designation as a contributor in the database can provide the reasonable expectation that will allow a wholesaler to identify revenue as wholesale and not retail.³⁴ But, this database is admittedly not perfect. Companies are routinely identified as non-contributors because they may have fallen behind on payments or other data processing errors by USAC or the FCC. (The database is so error prone that it provides companies with a phone number to call if they notice an error in their contribution status.) Further, even assuming that the database were 100 percent accurate, it only provides a snapshot of the status of a company today. But, despite these shortcomings, McLeodUSA's due diligence with the data it has available to it, demonstrates material errors in

³⁴ [REDACTED].

³⁵ March 2006 Form 499-A, Instructions at 17.

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USAC's conclusions that at a minimum have overstated McLeodUSA's end user revenue by \$4.2 million and by as much as \$6.05 million.

In addition to these factual errors, USAC committed legal error by deliberately ignoring FCC precedent and regulations in seeking payment of USF fees from McLeodUSA, the underlying carrier, instead of directly from any reseller that failed to contribute directly to USF. The FCC has stated repeatedly that resellers are responsible for paying USF fees and cannot rely on the wholesale provider.³⁶ This approach is consistent with longstanding FCC regulations that only sales to end users (and not resellers) are subject to USF contribution.³⁷ With regard to these services, McLeodUSA's carrier customer is not the end user. Instead it is the reseller who is providing those services to end users and who receives the benefits and revenue from those services from the end users who is responsible for paying these fees.

The Commission's own rules clearly state that "[f]ailure to file ... may subject the contributor to the enforcement provisions of the Act and any other applicable law."³⁸ Therefore, it is clearly those resellers that have failed to file or contribute who are subject to enforcement and who should be held responsible for the delinquent payment of USF fees, not McLeodUSA. Instead, USAC should seek payment of these USF fees directly from the resellers.

In fact, USAC and the FCC have a long history of enforcement actions against resellers for failure to register and pay fees. Just a few months ago, the FCC rejected petitions filed by American Telecommunications Systems, Inc., Equivoice, Inc., Eureka Broadband Corporation, Ton Services, Inc, and Value-Added Communications, Inc., resellers of telecommunications

³⁶ See *Comprehensive Review of Universal Service Fund Management, Administration and Oversight*, Report and Order, FCC 07-150 (Aug. 29, 2007).

³⁷ "Therefore, we conclude that contributions will be based on revenues derived from end user for telecommunications and telecommunications services..." *Federal-State Joint Board on Universal Service*, Order, 12 FCC Rcd 8776, at ¶ 844 (May 8, 1997) ("1997 Order").

³⁸ 47 C.F.R. § 54.713.

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service, regarding their payment of USF fees.³⁹ In the facts of that case, the resellers had paid their required USF contributions through their underlying carriers and therefore asserted they were in compliance with their USF obligations. USAC rejected that argument and held that petitioners had failed to contribute to the Fund as required. Upholding USAC's decision, the Commission held that the Petitioners had the "primary obligation to report such revenues and contribute" and that to the extent that the Petitioners had paid USF fees to the underlying carriers, a refund must be obtained from those carriers.⁴⁰ In issuing that decision, the Commission again confirmed that resellers must contribute directly based on their revenues. "[T]he Commission recognized that 'basing contributions on end-user revenues ... will relieve *wholesale carriers* from contributing directly to the support mechanisms' because these carrier's carriers do not earn revenues directly from end-users. Instead, *the reseller* that provides the service to the end-user and thereby earns end-user revenues will contribute directly to universal service."⁴¹

Despite the FCC decision, through this audit, USAC is attempting to charge the wholesale carrier, McLeodUSA, the USF fees rightfully owed by the reseller who is the carrier truly earning the revenue from the end user. Contrary to the *Reseller Decision*, USAC is improperly holding McLeodUSA responsible for the resellers' failure to contribute.⁴² In rejecting these resellers' petitions and requiring them to pay USF directly as end users, the FCC reinforced its policy that it is the responsibility of the reseller to register and pay USF directly

³⁹ See *Federal-State Joint Board on Universal Service (Petitions of American Tele. Sys., Inc., Equivoice, Inc., Eureka Broad. Corp., Ton Services, Inc., and Value-Added Communications Inc.)*, Order, 22 FCC Rcd 5009 (March 14, 2007) ("*Reseller Decision*").

⁴⁰ *Id.* at ¶ 7.

⁴¹ *Id.* at ¶ 3 (citations omitted) (emphasis in original).

⁴² This assumes that the reseller customer of McLeodUSA failed to contribute to USF for the relevant period. As already stated, because many of McLeodUSA's customers are well-known ILECs and CLECs, McLeodUSA believes it is much more likely that these resellers have in fact contributed to USF and that USAC did not review its own databases necessary to make that determination.

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and that underlying carriers are not responsible for charging resellers USF fees or for paying on their behalf. However, USAC has ignored and acted contrary to this clear FCC precedent by doing exactly that, and making the underlying carrier, McLeodUSA, responsible for and liable for the USF fees of reseller carriers (some of whom may have failed to comply with the rules and make direct contributions to USF).

In addition, by holding McLeodUSA responsible for the revenue received by its reseller customers, USAC is acting anti-competitively and favoring one type of carrier over another. The FCC specifically expressed its concern that USF fees could create an anti-competitive environment and could negatively impact carrier business decisions. "We seek to avoid a contribution assessment methodology that distorts how carriers choose to structure their businesses or the types of services that they provides.... Although it will relieve wholesale carriers from contributing directly to the support mechanisms, the end-user method does not exclude wholesale revenue from the contribution base of carrier that sell to end users because whole charges are built into retail rates."⁴³

If USAC receives payment of USF fees based on this revenue from both McLeodUSA and the reseller company, it will improperly benefit from double-recovery, which is clearly contrary to FCC regulations. "Basing contributions on end-user revenues, rather than gross revenues, is competitively neutral because it eliminates the problem of counting revenues derived from the same services twice. The double counting of revenues distorts competition because it disadvantages resellers."⁴⁴ In its attempt to reclassify revenue from wholesale to retail, USAC ignored the facts provided by McLeodUSA and information that was available to USAC with only a modicum of effort and inquiry. Similarly, the Final Audit Report ignores

⁴³ 1997 Order at ¶ 846.

⁴⁴ *Id.* at ¶ 845.

FCC precedent and attempts to assess USF on McLeodUSA's wholesale revenue. Such a result is wrong as a matter of law, and is bad policy, as it creates an anti-competitive advantage for certain carriers.

Finally, it is contrary to the requirements of the APA for USAC to rely upon reseller certifications and to shift the payment burden by requiring underlying carriers to pay the USF fees of reseller carriers (some of whom may be delinquent in their USF contributions). As noted above, because USAC simply asked for certifications and performed virtually no independent inquiry, USAC reclassified reseller revenue as end user revenue, even though many companies were registered and listed as contributors in the FCC's own database. Such reliance on the suggested certification process was misplaced and amounted to a *de facto* rule of requiring certifications. While the FCC has recommended the use of certifications in the Form 499-A instructions,⁴⁵ they are not required by the FCC rules and regulations.⁴⁶ As such, USAC's overwhelming reliance upon them, to the exclusion of other evidence, amounted to the establishment of a new substantive rule which USAC is not authorized to implement and that was not subject to the APA's required notice and comment procedures.⁴⁷

In addition, USAC ignored FCC precedent in the *Reseller Decision*⁴⁸ which clearly indicated that resellers, and not underlying carriers, are responsible for the payment of their USF fees. When USAC ignored FCC rules and precedent by requiring McLeodUSA to pay the USF fees owned by its reseller carriers it violated the APA. Such a revision or re-writing of the rules cannot be implemented through USAC's audit process or through inclusion in the instructions to

⁴⁵ March 2006 Form 499-A, Instructions at 17.

⁴⁶ See *Reseller Decision* at 5012 (While the FCC has developed a certification process, it is not mandatory. "[T]he Commission has a certification procedure in place that underlying carriers *may* use to determine whether the entities to whom they offer telecommunications or telecommunications services for resale are in fact direct contributors.") (*emphasis added*).

⁴⁷ 5 U.S.C. § 553 (b)-(c).

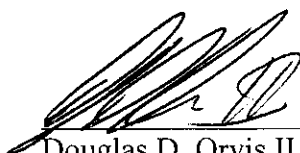
⁴⁸ See *Reseller Decision* at 5012 ("[R]esellers generally bear the obligation to contribute directly to universal service because resellers earn revenues directly from end-users.").

its forms, but must be subject to the APA required notice and comment process. While holding underlying carriers responsible for the payment of the USF fees of resellers may be *easier* for USAC than actually enforcing the payment provisions against the resellers, USAC lacks the authority to do so and hence, its Audit Finding #5 is in violation of the APA.

IV. CONCLUSION

Based on USAC numerous factual inaccuracies committed in the Final Audit Report, McLeodUSA respectfully requests that Commission reverse USAC Audit Findings #1, #2 and #5.

Respectfully submitted,



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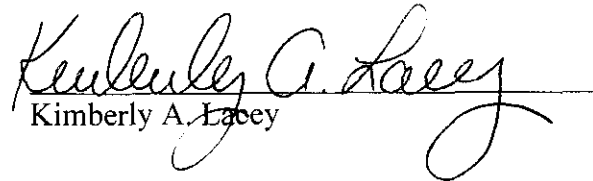
Dated: October 1, 2007

CERTIFICATE OF SERVICE

I, Kimberly A. Lacey, hereby certify that on this 1st day of October 2007, a copy of the foregoing "**McLeodUSA Telecommunications Services, Inc. Request for Review of Universal Service Administrator Decision**" in CC Dockets No. 96-45 and 97-21, was served via hand delivery to the following parties.

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